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Say on Pay So Far

The most important development this proxy season has been the new requirement under Dodd-Frank that all public companies hold an advisory "say on pay" vote. The following are our observations on "say on pay" thus far this proxy season.

Results of General Vote. As of May 6, 2011, all but 15 of the 807 companies that have reported results with respect to their say on pay votes have received favorable votes, with over 2/3 of companies receiving more than 90 percent favorable votes.

Influence of Proxy Advisory Firms. The recommendations of Institutional Shareholder Services (ISS) have had a measurable impact on voting results. ISS has recommended against say on pay proposals at approximately 12 percent of companies holding such votes. Of companies receiving unfavorable vote recommendations from ISS, 11 out of 60 that reported results as of April 29, 2011 failed to receive majority support. Companies receiving negative ISS recommendations that have nonetheless passed have generally done so with considerably lower margins than those receiving favorable vote recommendations. No company receiving a positive recommendation from ISS has failed to receive a majority support.

The influence of Glass Lewis, the other major proxy advisory firm, appears thus far to have been minimal. Glass Lewis has recommended against a strikingly high percentage of companies, and perhaps for this reason, has influenced voting results by approximately three percent or less. In our experience, many companies have determined not to address directly criticisms raised by Glass Lewis.

Reasons for Negative Vote Recommendations. In approximately 85 percent of the situations in which ISS has recommended a vote against say on pay, it is because ISS believes there is a "pay for performance disconnect." A "pay for performance disconnect" generally exists if both one-year and three-year total shareholder return are in the bottom half of the company's GICS industry group and the total compensation of the CEO as reported in the summary compensation table is in ISS's view not aligned with total shareholder return over time. Most frequently, the disconnect is found to exist if there is an increase in year-over-year compensation of the CEO.

ISS may also recommend against a say on pay vote if the company has engaged in so-called problematic pay practices. In our experience, problematic pay practices generally result in an unfavorable vote recommendation only in those circumstances that ISS deems "egregious." Such circumstances most commonly include (1) option repricings without shareholder approval, (2) excessive perks or grossups or (3) entry into new or extended agreements that provide for "golden parachute" excise tax grossups or single trigger severance payments (such grossups are probably the most common reason that ISS provides a negative recommendation due to a problematic pay practice).

Problems with the ISS Methodology. ISS' methodology is problematic for several reasons. First, it is a "one size fits all" test that does not accurately take into account the different needs and goals of different companies and focuses on form over substance in executive compensation. Second, the peer group used by ISS to determine whether a particular company is performing well is the GICS group, which often bears little to no relation to the peers against which a board might assess corporate performance for many reasons including the size of the GICS group and the varied size of the companies comprising the group. Third, ISS only looks at compensation as reported in the summary compensation table, a blunt instrument that can result in widely different results for companies paying executives in different forms. For example, a stock award based on the achievement of performance goals will generally appear in the summary compensation table in the year of grant, where a cash award will only appear, if at all, in the year in which the performance goals are achieved and the award is paid. As a result, a company might pass or fail ISS' pay for performance test based solely on the form – cash or stock – of the award. Fourth, ISS does not consider time based stock options or restricted stock as performance based compensation. In addition, ISS' TSR statistics are annual – not compounded – and are derived from a third party source. If the third party gets it wrong, then ISS gets it wrong and makes no further inquiry or changes. Moreover, because of ISS' focus on one and three year TSR, companies that managed well through the financial crisis have been, and will for the next few years be, at a disadvantage in the relative TSR test. Finally, and perhaps most importantly, ISS has never offered evidence that the practices that they seek to prevent adversely affect corporate performance or shareholder returns. In fact, a recent Stanford University study demonstrates that ISS' position on option exchange programs decreases shareholder value.

How to Win the Vote. If ISS recommends in favor of a company's say on pay vote, there is little that needs to be done to ensure that shareholders will vote in favor of the company's compensation arrangements. If, however, ISS recommends against the say on pay vote, there are several actions that a company may wish to consider taking to help ensure a successful result.

- *Understand How Compensation Programs Stack Up Against ISS Standards.* While there is no need to conform executive pay practices to ISS standards, companies should understand where their practices deviate from ISS standards and be prepared to explain why their practices deviate.

- *Assemble a Task Force*. ISS usually provides companies with a draft copy of its recommendations 24 hours in advance of making the recommendation. To be in a position to timely respond, companies should anticipate the likely timing of the release of the draft report, assemble a task force in advance of its receipt and ensure that task force members will be available to respond to the report. In preparing for the report, companies should be aware that ISS may issue the draft report over the weekend.

- *Know Your Limits*. As blunt an instrument as ISS' approach may be, comments on the ISS report should not focus on criticizing ISS' methodology, which in our experience ISS is unwilling to change in connection with this process. Instead, comments should focus on factual errors in the report and on toning down rhetoric in the report that

may be inflammatory but irrelevant to the say on pay question. While ISS is not always willing to fix errors in their report, they are willing to do so from time to time.

- *Reach out to Shareholders*. There is no technique that is more effective in winning the vote than direct shareholder outreach. The difference between companies that have passed and those that have failed the vote when ISS recommends against a say on pay resolution is often willingness to engage directly with shareholders.

- *Importance of Listening*. Meetings with shareholders should be viewed as an opportunity to listen to shareholder concerns. It is often unnecessary to communicate any particular message to shareholders; the mere fact that companies meet and listen to shareholders can result in a favorable result. That said, companies should be prepared to discuss concerns raised by shareholders with respect to pay practices.

- *Who Should Speak*. While some have recommended that only board members, lead directors or compensation committee chairs should speak with shareholders, in our view the question of who should speak with shareholders depends on the reason for shareholder concerns about the company's practices.

- *Using Relationships with Investment Decision Makers*. Companies should consider reaching out directly to those making investment decisions. Investment professionals may be satisfied with the company's performance, may not be aware that the say on pay vote is an issue and may be surprised to learn that their organization's governance department is taking action against the company's board. Communicating directly with investors can prove helpful in this context.

- *Consider Supplemental Materials*. Many companies have filed supplemental proxy materials as a way to communicate directly with their shareholders. Sometimes these materials merely reiterate principles set forth in the CD&A; sometimes they convey new information. Either way, such materials may help companies to reach investors who they may be unable to meet with in-person.

- *Changing Compensation Practices*. While ISS has made clear that prospective commitments to change compensation practices will not be effective in changing its recommendation, ISS has changed its vote recommendation where companies have agreed to change compensation practices retroactively. For example, ISS agreed to change its recommendation when Disney removed "golden parachute" excise tax grossups from agreements with several senior executives. Similarly, ISS changed its recommendation when GE added performance goals to CEO Jeffrey Immelt's stock option grant. This will not be a solution for most companies, nor should companies make substantive decisions in order to win the support of ISS. However, it has proven successful in certain circumstances and may be appropriate where a company feels upon reflection that the criticism leveled by ISS or by other investor groups is valid. Either way, it is important for directors to understand that there is no legal obligation to change corporate policy in response to the threat of a negative vote if the director's

business judgment tells them that existing compensation programs are well-designed and are working well.

Getting a "No" and Director Liability. While there has been heavy coverage of lawsuits deriving from negative say on pay votes at certain companies, courts will protect directors' decisions so long as the directors act on an informed basis, in good faith and not in their personal self interest. In fact, the Dodd Frank Act expressly states that the shareholder vote "may not be construed" to "create or imply any change to the fiduciary duties of such issuer or board of directors" or to "create or imply any additional fiduciary duties for such issuer or board of directors." If a company receives a negative vote, it should consider the reason for the negative recommendation and, with the advice of an independent compensation consultant, consider whether it wishes to revise the practice. If a board follows appropriate procedures in its review process, there will be no legal liability. Directors therefore need not be deterred from paying executives in amounts and forms that they deem necessary or advisable to attract, retain and incentivize executives, regardless of the results of the "say on pay" vote. Indeed, doing so effectively is one of the highest priorities for any board of directors.

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